For Financial Professional Use Only

Global Investment Strategy and Asset Allocation
The "big bang" into an alternative universe

Morningstar Investment Management Europe Ltd
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Contents

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How to Use this Report
This report is intended to showcase the investment philosophy used by Morningstar Investment Management Europe Limited when we run our managed portfolios. Within this document, the reader will find many references to valuation-implied returns, which encompasses our extensive proprietary research into capital markets.

We invite professional readers to generate ideas and challenge the content herein.

Note from the CIO

The investment landscape is changing in many ways, yet remains firmly grounded in others. We have witnessed at least three sizeable shifts since the 2008 financial crisis - with the rise of passives, the contraction of yields and the popularity of 'alternatives' at the top of mind.

These each play an important role in our thinking, as we seek to minimise costs (rise of passives), maximise reward for risk (consider yields) and think about portfolios holistically (utilise the benefits of alternatives where appropriate).

These investment trends will undoubtedly impact every investor over the coming decades, from retirees to the youth of today. We know that the tailwind of easy money is likely to be behind us and that the long haul to 'normalisation' could have a dramatic impact on the investment landscape. We find that this is most pervasive within fixed income markets (low starting yields and long duration are not typically considered a recipe for success), but will be felt right through into the alternative universe.

While we wouldn't quite go as far as reframing "absolute returns" to "absolutely no return", an investor will need to be more careful than ever as they contemplate the management of their life savings. Encouragingly, education standards continue to rise and risk analytics tools are only becoming more advanced; both of which will greatly support the pursuit for investment excellence. Of course, it won't be without its challenges, but we remain confident that gravity will continue to exist and that a long-term valuation-driven approach is the grounding force that will drive outcomes.

With this background in mind, we explore a number of topical issues in this edition:

- **Is 'growth' or 'value' the winning approach?** While investment style is important to equity attribution, it is rarely considered in a multi-asset context. What style works for the holistic investor?
- **Smart diversification for retirees.** With yields near record lows, retirees are being forced to contemplate the appropriateness of their 'safe withdrawal rate'. What options do they have?
- **Are global holdings worth the hassle?** Investing offshore can often add currency volatility and an added layer of complexity. We explain the way we approach it and why it is a rewarding endeavor.
- **Three important things to know about elections and the markets.** Election results are having a profound impact on speculative activity. We explore what really matters.
- **A reality check for alternative UCITS.** The rise of alternatives continues despite some disappointing performance numbers. We unearth the 'alternative UCITS' universe.
- **Is the popularity of the CFA a bad thing?** The markets are getting increasingly educated, which should theoretically make markets more efficient. However, this isn't evident in the numbers yet.

Key Convictions
Long-term outlook of the global asset allocation team

Exhibit 1 The global asset allocation outlook shows pockets of danger and opportunity.

Asset Class		Overall Conviction	Key Long-Term Drivers
EQUITIES	United States	Low	Valuation pressures continue to be our primary concern. Profit margins remain elevated, although have eased from high levels.
	Europe ex-U.K.	Low to Medium	Return on equity remains depressed across large parts of Europe, however valuations look fully priced from current levels.
	U.K.	Medium	U.K. equities are a tale of two markets. The FTSE 100 has scope for improving earnings, while the FTSE 250 has fundamental headwinds.
	Japan	Medium	Structural reform could provide upside to earnings drivers. Relative to other regions, valuations also remain fairly positioned.
	Australia	Low	Unlike other parts of developed Asia, Australian equities offer a poor long-term outlook due to abnormally elevated profit margins.
	Emerging Markets	Medium to High	Unloved areas such as emerging Europe offer broad fundamental appeal, whereas Latin America faces valuation pressures.
FIXED INCOME	U.S. Treasuries	Low to Medium	Valuation-implied returns are improving from very low levels, but still barely cover inflation risks.
	U.S. TIPS	Low to Medium	Breakeven inflation rates seemingly offer decent prospects relative to nominal bonds, although duration risk still weighs on the outlook.
	U.S. Credit	Low to Medium	Relative to U.S. Treasuries, yields are becoming increasingly unattractive. Reward for risk remains relatively low.
	Euro Treasuries	Low	European bond yields remain low in absolute and relative terms. With political risk also a factor, the asset class remains unfavourable.
	European Credit	Low	Face similar duration risk to European Treasuries, despite credit spreads close to fair value. Valuation constraints remain a problem.
	U.K. Gilts	Low	U.K. gilts have abnormally long duration risk, offering low reward for risk in a long-term context.
	Australian Treasuries	Medium	Australian treasuries offer relatively attractive yields by fixed income standards, increasing the allure of the asset class.
	High Yield	Low to Medium	High yield spreads have tightened considerably, reducing the likelihood for future gains. We therefore advocate increasing caution.
	Emerging Market Debt	Medium to High	Local currency exposure remains attractive due to high relative yields and depressed currencies. There is adequate reward for risk.
SPECIAL MENTIONS	Real Estate	Low	REITs offer an attractive yield but the outlook requires caution. We cite poor earnings prospects in both relative and absolute terms.
	European Financials	Medium	Acknowledging the wide range of cash-flow outcomes, the valuation appeal is compelling as assets are priced below book value. We note some of this has now been captured.
	Pound sterling	Medium to High	Sterling still appears undervalued in fundamental terms despite the implications of Hard-Brexit. Multiple deflators remain attractive.
	European Energy	Medium	Capital expenditure cuts should help to defend dividends, the largest part of the expected return. The undervaluation has largely corrected.
	U.S. Healthcare	Medium	Valuations remain stretched, but offers a relatively stable yield and earnings profile. This is tempered by regulatory and M&A risk.

Source: Morningstar Investment Management, conviction levels confirmed at 31/05/17.

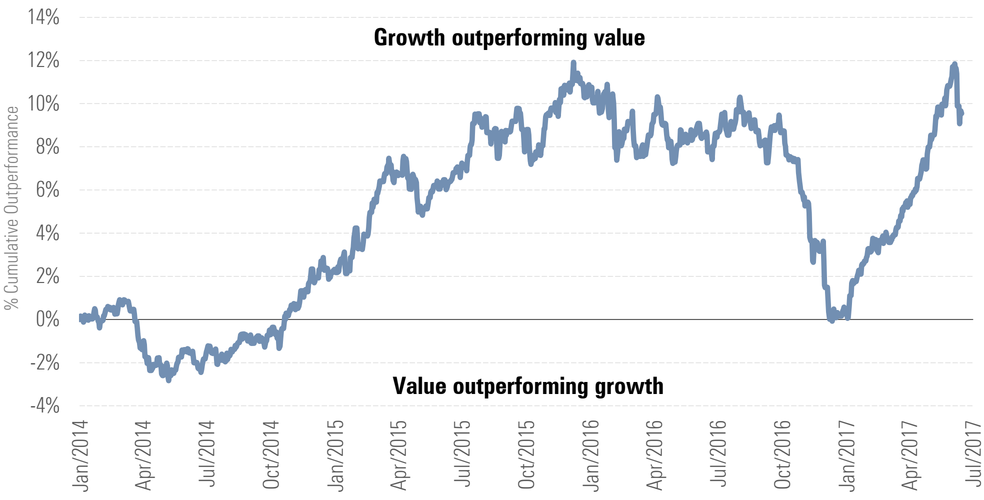
Equity Market Valuations
Is ‘growth’ or ‘value’ the winning investment style?

Warren Buffett’s business partner Charlie Munger famously said that “all intelligent investing is value investing, acquiring more than you are paying for”[1]. Yet professional investors are regularly defined by their ‘investment style’. When asked who Benjamin Graham was, most investors would describe him as ‘the father of value investing’ while Peter Lynch was known to focus on investing in companies that he believed would grow faster than average. The labels provide a shorthand to help investors quickly describe the approach of an investor.

In common with other stereotypes, the labels ‘growth’ and ‘value’ naturally oversimplify the approach adopted by investors, especially those such as Graham and Lynch who were highly skilled as investors. Nevertheless, the division between value and growth has become the embedded in the way people think about investment.

Over the long term, several academics have shown that cheap shares deliver higher returns than expensive shares over the long term[2]. As value investors typically seek cheap shares and growth investors are usually characterised as those prepared to pay premium prices for higher earnings growth, this suggest that ‘value investors’ should outperform. However, the reality is that over short time periods, the relative performance of the two styles is cyclical. Specifically, growth is said to be dominating against value to the tune of approximately 10% year-to-date, raising many questions about whether it is a contrarian signal or whether growth stocks are better positioned for today’s ‘low return’ world.

Exhibit 2 Within equities, a growth bias has been rewarding in recent times.

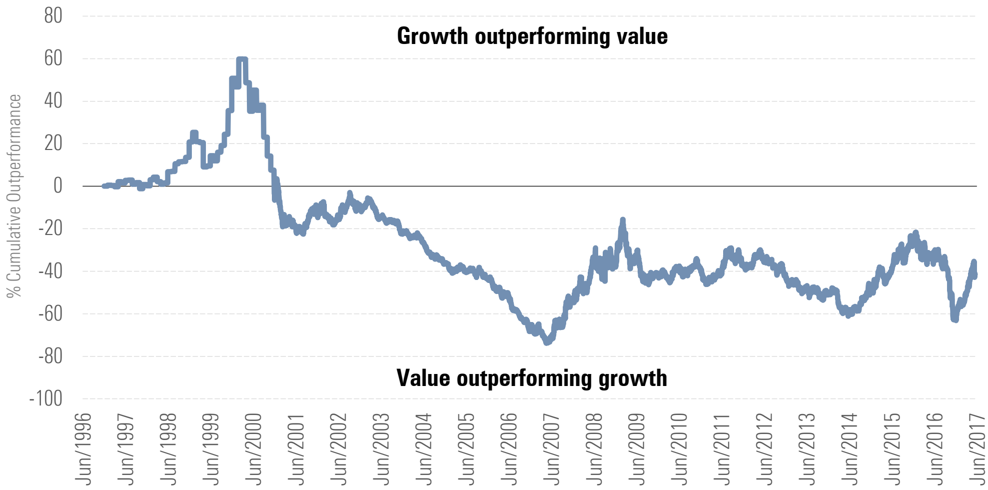


Source: Morningstar Direct, Morningstar Investment Management calculation at 31/05/17

[1] From ‘Charlie Munger: The Complete Investor’ by Tren Griffin (2015)

[2] See Fama and French ‘Value versus Growth, the international evidence’ (Journal of Finance, Dec 1998)

Exhibit 3 The longer term shows a value bias winning within equity markets.



Source: Morningstar Direct, Morningstar Investment Management calculation, at 31/05/17

It is interesting to apply a far broader perspective though. Equity style factors can tell us a lot about what caused a manager's return to be higher or lower than an index and gauge whether outperformance or underperformance is due to that style of investing being in or out of favour. This has two important uses that can improve performance. First, it allows us to better gauge how much of past performance is due to skill and luck rather than style. Furthermore, it can also be used to combine managers with very different investment approaches to generate more consistent outperformance.

What about multi-asset portfolios?

We know that the asset allocation is the key driver of the absolute return of a portfolio, so are there styles of investing in terms of what drives asset allocation decisions? For multi-asset portfolios that vary their asset mix, we see three common ways of forming views about the investment outlook and varying the asset allocation:

- **Macroeconomic-driven –** the key driver of the asset allocation decision is the managers' economic research and views on the outlook for economic growth, inflation, interest rates and so on. These are used to form a view about the outlook for markets, with the typical timeframe of up to 3-years.
- **Momentum-driven –** the key driver is the short- to medium-term trend in asset prices and in some cases underlying economic and corporate fundamentals such as GDP growth and corporate earnings. Portfolios are biased to assets whose prices have risen and in some cases high or rising growth.
- **Valuation-driven –** here the key driver is fair value estimates, which are then used to identify investments offering better value and reward for risk. Portfolios tend to hold more "out of favour" assets and be more contrarian. A fundamental longer-term perspective is required in terms of assessing fair value, implying a discipline to "miss out" on gains when markets become euphoric as well as the patience to wait for prices of out of favour assets to rise back to more sustainable levels.

These multi-asset "styles" can be used to understand how funds might perform in different market conditions. Momentum strategies often perform best when trends are strong. However, they struggle when markets fluctuate sharply within wide ranges. Macroeconomic-driven strategies are less predictable as they are driven by subjective forecasts of economic conditions and their market impacts.

Valuation-driven strategies tend to perform less well when markets are expensive and prices continue to rise but perform much better in market sell-offs.

So, which style does best over the longer term?

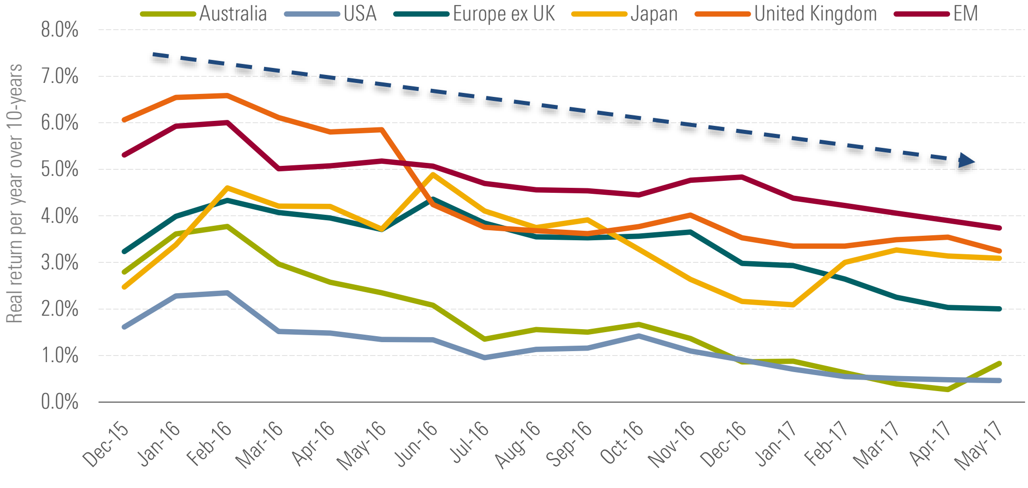
We can draw some useful conclusions from the track record of forecasters, the history of financial markets and behavioural finance.

First, the record of forecasting is very poor. This applies to economic variables like GDP growth, inflation, corporate profits and interest rates as well as asset prices including share prices, bond yields and exchange rates. Once fees and taxes are included, the odds are stacked against you if you base your investment strategy on short- to medium-term forecasts.

Second, equity markets are prone to trends in the short- to medium-term but not over longer horizons. In fact, over longer periods returns are more stable meaning that periods when markets trend up are followed by periods when prices fall. Momentum investing tends to work better over shorter horizons but is exposed to large losses when a reversion in return happens. This makes the approach vulnerable to large losses.

Third, there is a link between the valuation of an asset and future returns and losses. When markets trade at the low end of their historic valuation ranges, future returns are higher than usual and future losses (peak to trough fall in share prices) smaller than usual. Conversely, when they trade at the high end of their valuation range, future returns are lower and losses greater than usual. Behavioural finance has shown that it is hard to apply this approach of being contrarian, in part because our instincts are to extrapolate recent experiences and be part of the crowd rather than be alone. Incentives in fund management are also generally shorter term and do not reward patience.

Exhibit 4 This is an example of our valuation-driven approach, showing that our long-term expectations continue to deteriorate. This acknowledges greater price pressure and helps us overcome behavioural biases (10-year valuation-implied returns, real % per year).



Source: Morningstar Investment Management calculation, at 31/05/17

In summary, which style wins?

While it is not without its challenges, our conclusion is that a multi-asset investor could enhance their chances of success if they support a fundamentally long-term and valuation-driven approach.

Fixed Income Valuations
Smart diversification for retirees

Investing in retirement is especially challenging as the investors are typically operating within an uncertain timeframe and battling the return drag caused by regular withdrawals to fund expenses. While such challenges require all of the tools at the disposal of the investment manager, for the majority of mums and dads saving for retirement, the use of fixed income is the most important consideration, as these assets typically provide greater certainty in the short term together with a useful income stream.

Traditionally, a simple retirement proposition may have comprised fixed income and equities to achieve a ‘safe withdrawal rate’ as an income stream. However, as the investment universe has expanded and interest rates pushed lower, this ‘safe withdrawal rate’ has seemingly declined. In a modern context, the portfolios used in retirement typically now include property, infrastructure, commodity-related assets, currency exposures and other ‘alternatives’.

So, how do these assets complement fixed income? While this causes a significant amount of confusion for everyday investors, it is worthwhile stepping through the benefits of smart diversification and the ways one can think about improving total portfolio outcomes.

The equity/fixed income split
To start with what is most important, the equity to fixed income split still remains the single biggest contributor to portfolio returns and risk in the vast majority of instances.

The reason for this isn’t necessarily due to correlations, but rather due to sizing. We can see the way this works in the standardised correlation matrix below, showing the 10-year correlation between U.K. equities, U.K. fixed income and other assets. As a generalised statement, a retiree yearns for low correlations between their key exposures as it diversifies the performance drivers and can smooth outcomes.

Exhibit 5 The correlations between asset classes over the past 10-years.

Correlation of Major Asset Classes	UK Government Bonds	UK Corporate Bonds	UK Equity
Global REITS	0.26	0.50	0.68
Hedge Funds	-0.20	0.46	0.73
Gold	0.39	0.12	-0.02
Private Equity	-0.10	0.40	0.83
UK Direct Property	-0.19	0.11	0.21
Emerging Markets Equity	0.02	0.40	0.78
Commodities	-0.07	0.10	0.42
UK Government Bonds	1.00	0.54	-0.07
UK Corporate Bonds	0.54	1.00	0.50
UK Equity	-0.07	0.50	1.00

Source: Morningstar Direct, Morningstar Investment Management calculation, at 31/05/17

Interestingly, an investor that has been predominately focused on fixed income could seemingly do a better job of diversifying than a simple fixed income/equities split. For example, the correlations to property, private equity, commodities and hedge funds have also offered diversification benefits over the past 10-years.

So, does this mean a defensive investor would be better placed mixing government bonds, private equity, property, hedge funds and commodities? Not necessarily.

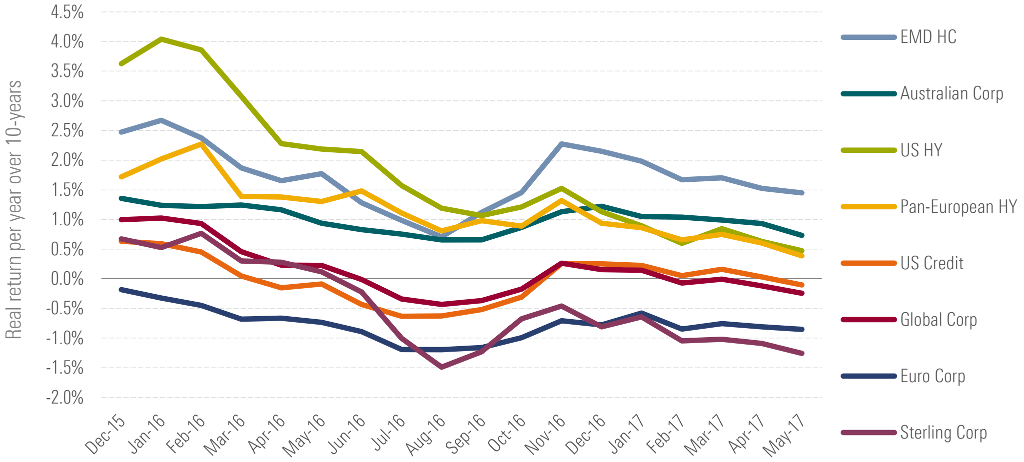
Correlations are very useful in understanding relationships, however can be grossly misleading in understanding the total portfolio impact. The problem here is that correlations only explain the way the assets move together on average. It fails to tell you that these relationships can break down for considerable periods in stress. It also fails to tell you anything about valuations and the contributions to risk or return.

Thinking in a valuation-driven context

A better way to think about diversification is to assess 'valuation-conditional drawdowns'. Specifically, assets with lower valuations typically deliver higher returns and suffer lower drawdowns. The deeper the drawdowns, the more capital the retired investor will have to sell to generate sufficient income. Furthermore, the more capital they sell the less they will have to deliver future returns. This spiral effect can cause the 'safe withdrawal rate' to decline.

To take this to the present, there is no point comparing bonds at a 2% yield and expecting it to act the same way to when they offered a 10% yield. Similarly, one shouldn't compare an equity market trading at an all-time high and expect it to behave the same way as an equity market that has already fallen 50%. Valuations matter.

Exhibit 6 Valuation-implied returns for fixed income remain very unattractive in absolute terms. However, on a relative basis, there is scope for selective holdings (% per year in real terms after inflation).



Source: Morningstar Investment Management calculation, at 31/05/17

The complexity of interpreting such information in a total portfolio context should not be underestimated and there are at least three or four problems in comprehensively assessing this. First, an investor needs to have a means of understanding how expensive or cheap an asset is relative to 'fair' value. Second, they then need to understand the way an expensive bond may move relative to an expensive/fair/cheap asset. We devote a lot of time to producing these (as above) as critical inputs to a valuation-driven risk assessment.

Unfortunately, the problems don't end there either. Inherent within all of these assessments are data reliability issues and historical objectivity. Obtaining sufficient long-term track records can be practically impossible in an asset class such as the emerging markets. It is especially difficult to compare apples with apples when one asset such as US equities has a historical record back to 1871 and another such as emerging market debt only back to 1996. The second element is related to experience. For example, assessing valuations for the technology sector relative to the utilities sector can be difficult due to varied drawdown histories. Utilities simply haven't experienced the equivalent to a 'tech wreck', even though they tend to carry debt levels that wouldn't rule out such a disaster. The same can be said for shifting markets. While emerging markets are the obvious candidate, even global fixed income has seen dramatic shifts over time as Japan raised more and more debt via government bond issuance.

So, is it possible to accurately assess 'valuation-condition drawdowns' relative to the valuation-implied returns? Absolutely. The solution is to consider both historical and simulated outcomes. While the historical analysis is useful in checking how a portfolio would have reacted in a financial crisis, the simulated outcomes also allow one to consider the unknown. It is backward-looking meets forward-looking – and while there are issues in the design, it is all about reducing the ignorance one carries and to improve the total portfolio outcome.

Also contemplating 'contribution to risk'

A further test that helps increase the awareness of possible outcomes is to recognise the contribution to risk. Said simply, it is not good enough to blend emerging market debt, high yield debt, commodities and the energy sector just because it 'looks' diversified. This is true even if it offers a strong return outlook. Let's take a hypothetical retiree portfolio that achieves an overall split of 60% fixed income, 20% equities, 10% cash and 10% alternatives. Which asset offers the biggest contribution to risk? Equities, fixed income or alternatives? Are there any 'factors' influencing this contribution to risk? Risk analytics tools are very powerful at answering these questions and can offer far more insight than a simple correlation matrix.

Bringing this back to the goal of investing

Portfolio construction is an underrated element of the investment process. Using risk analytics tools are a great way of reducing any ignorance while building robust solutions – however they are not a silver bullet. Ultimately, a portfolio is there to achieve outcomes, but the future cannot be predicted with precision and it is not possible to create something out of nothing. This reinforces the need for a total portfolio viewpoint. It also emphasises the requirement for advisers to help clients by ensuring that they are not trying to achieve the impossible and drawing too much income. Therefore, portfolio construction should start with sound limits and an understanding of how behavioral biases can upset returns.

To say this another way, portfolio managers are constrained to the universe they are playing in. As Warren Buffett said, "you can't create a baby in a month by getting nine women pregnant"[3]. If a retiree wants to maximise reward for risk, these tools are incredibly powerful and smart diversification can help them achieve peace of mind.

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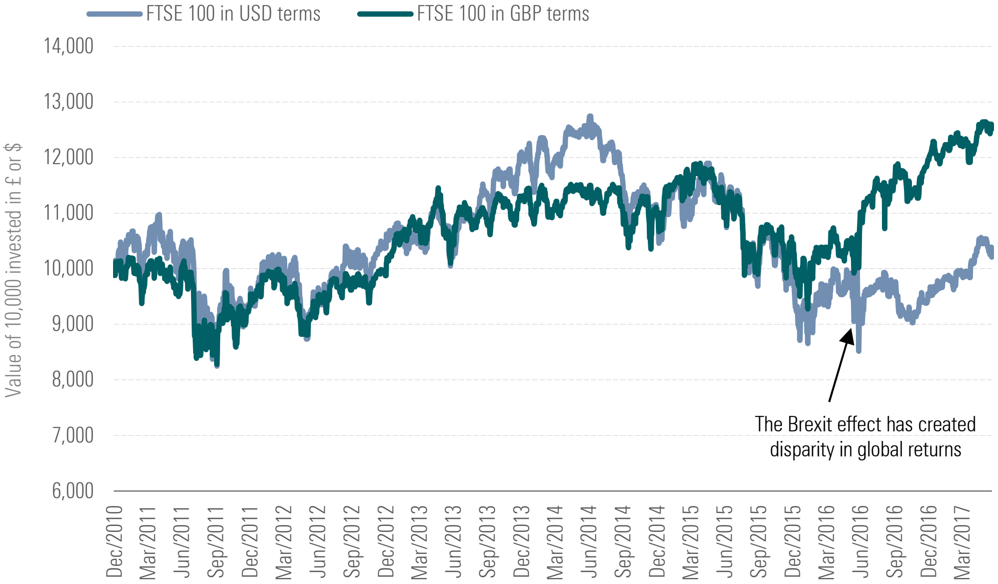
[3] Sourced from Berkshire Hathaway's Letter to Shareholders (1985)

Currency Valuations
Are global holdings worth the hassle?

The debate between the home bias and international diversification is alive and well. Events such as the Brexit referendum and the Donald Trump election victory certainly amplify the matter, as currency volatility has spiked, placing these assets in the focus of investors from both a risk and return perspective.

While this acts as a nice tailwind for those on the right side of the trade – especially British and Mexican domiciled investors in the past year – those on the other side such as U.S. investors have seen little reward for their global diversification efforts. This increases the speculative activity surrounding currency moves and adds a layer of doubt to the attractiveness of global holdings.

Exhibit 7 Local currency returns are reasonably stable; however, currency can have a dramatic impact to these outcomes.



Source: Morningstar Direct, Morningstar Investment Management calculation, at 31/05/17

The question everyone wants to know… do global holdings help a portfolio in the long term?
According to Nobel Prize winning theory, the more diversification the better. Harry Markowitz pioneered the concept that markets are efficient, and as such, one should maximise the variety of performance drivers in a portfolio to obtain a portfolio that sits as close as possible to the 'efficient market frontier'. This is a big endorsement for global holdings that has been embraced by both academia and many in the investment community.

Yet, to counter such a mathematically-driven concept, two of the world's most prominent investors – Warren Buffett and Jack Bogle – have publicly proclaimed that an investor can achieve great results by simply investing in U.S. domiciled assets[4].

Who is right? To answer such a question, we must first appreciate there are a series of issues that must be contemplated. We will tackle in turn:

- **Does a globally aware portfolio increase the opportunity set?**

While very few would disagree that a wider investment universe comes with more diverse opportunities, the question is whether an investor has the resources to execute on a truly global strategy. Where sufficient resources are not available, it is tempting for investors to fall back on assumptions and heuristics.

An example would be investors buying into in to the Hong Kong market to gain exposure to the Chinese consumer, whereas in reality, approximately 60% of Hong Kong market is financials and real estate which is often disconnected from the "rising middle-class" theme many seek to expose themselves to. A global strategy is therefore only useful if the investor is able to fully investigate the opportunities it contains and (to steal a phrase from Peter Lynch) know what they own and why they own it. Failure to do this is likely to end in disappointment.

It is also important to consider the global exposure one indirectly obtains from their local market. For example, while Warren Buffett and Jack Bogle seem to generally prefer U.S. equities, the fact is that approximately 44% of the U.S. top 500 companies (S&P500) revenue is obtained from offshore[5]. Companies with such high offshore revenues can act with similar sensitivity to pure global holdings.

- **Is it possible to determine the relative attractiveness of currencies?**

One of the key features of a globally diversified portfolio is the exposure the investor gains to the currencies of other countries. This additional exposure is naturally accompanied by risks and potential gains. In order to assess the attractiveness of this additional exposure, the investor must be able to assess the potential for both return and risk.

While many investors maintain that currency movements are unpredictable, applying a valuation-driven framework to currency analysis is entirely possible and can often identify pockets of significant opportunity. The key is to understand the mean-reverting nature of currency moves, which is best done by tracking the relative moves in underlying goods and services as currencies tend to return to purchasing power parity over time.

The most famous example of this is the Big Mac index, where one can see the price of a McDonalds hamburger in various countries. This example of a currency deflator model tracks the relative prices of goods/services and seeks to identify the outliers that no longer reflect 'fair value'.

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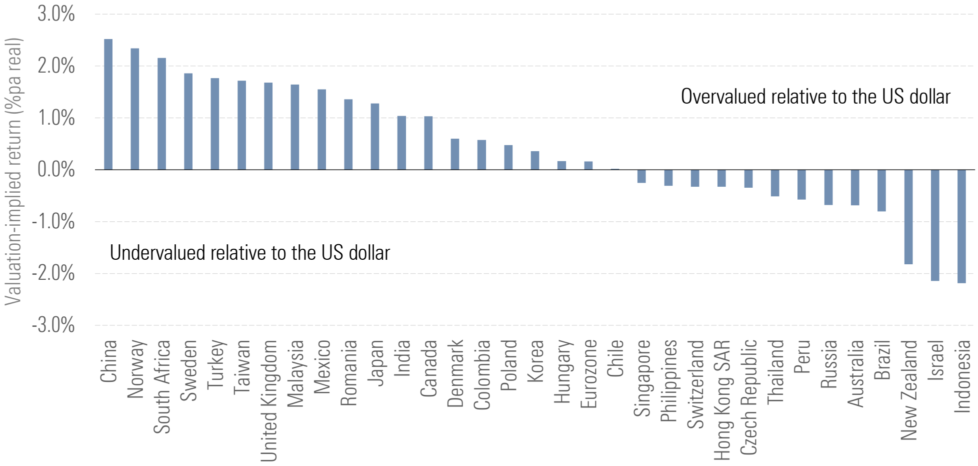
[4] http://www.cnbc.com/2017/04/17/a-stubborn-investing-rule-shared-by-jack-bogle-and-warren-buffett.html

5 http://us.spindices.com/documents/index-news-and-announcements/20160727-sp-500-global-sales-2015.pdf

Morningstar uses a three-pronged approach, which seeks to encompass the key drivers of long-term currency moves while avoiding the noise. This is depicted in the chart below, showing some of the outliers. While the market can remain irrational for extended periods of time, this gravitational pull can help portfolios maximise reward for risk.

Exhibit 8 Our assessment of currency valuations relative to the US dollar are depicted below, demonstrating the extent of the disparity. We find the US dollar is generally overvalued relative to the other majors.



Source: Morningstar Investment Management, Morningstar Direct as at 31/05/2017

- **How much downside risk can currency add to a portfolio?**

Currency can have a substantial impact on portfolio drawdowns if it is not managed appropriately. This increases the importance of risk analytics, where the exposure to any offshore currency should be thoughtfully contemplated. While this is also true for companies with significant exposures abroad, the key here is to have an appreciation of the way the asset will move under stress.

It is also important to look at it from the contrarian angle, as one can potentially reduce portfolio drawdown risk by obtaining exposure to 'cheap' currencies that are undervalued relative to the domicile of the investor.

- **Are hedging options available to offset any currency risk?**

From time to time, there will be scenarios where an investment opportunity is apparent but the currency exposure looks expensive. Conversely, we can also witness scenarios where the currency looks attractive but the underlying investment opportunities are scarce.

A key consideration as we assess the currency valuations is whether it is likely to add or detract from the investment proposition. This must be considered in both a return and a risk context. More specifically, we want to understand the impact any unexpected currency move would have on the whole of the portfolio. If we expect the global holding to benefit from a currency tailwind (plus we are comfortable with any downside risks to this thesis), then there is a solid case for obtaining such exposure.

In the opposing event, where currency poses a risk, hedged investments may be considered. These are often (but not always) available, which effectively helps an investor split out the investment decision from the currency implications. While this can greatly benefit portfolio outcomes by isolating the opportunities, one must also be aware of the 'cost of hedging' they often unknowingly accept (the effective interest rate differential).

It is also worth noting the benefits of using fundamental analysis and applying an intellectual overlay to any research. For example, a currency such as the Chinese yuan (ranked as the cheapest based on the deflator model) may not revert according to our gravitational concept. As hedging is difficult to achieve within Chinese markets, it would be irrational to blindly exposure yourself to the Chinese yuan without contemplating the motivations that underpin the cheap currency. Specifically, the Chinese want the yuan to be cheap as it helps their exports, which is unlikely to change as a motivator.

Putting this in perspective

The challenges inherent in global investing can be cumbersome but rewarding. It requires an investor to understand both the investment decision and the currency implications, with the latter typically carrying greater uncertainty in the outcome.

From a practical standpoint, this requires a pragmatic and repeatable process that can assess the global universe, whilst having the appropriate global resources to appreciate the holistic considerations. The key here is to remove ignorance from the investment decision and garner a greater understanding of the total portfolio outcome. If done correctly, the rewards can be significant with no additional use of capital.

Fundamental Considerations
3 important things to know about elections and markets

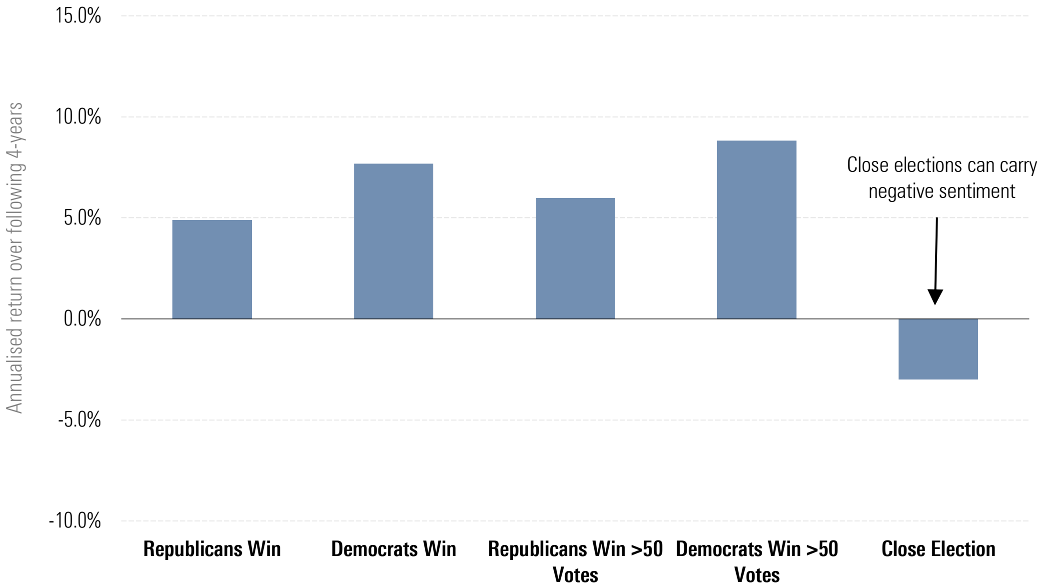
People love to speculate on the result of an election and investors are not immune from this urge. In the past 12 months, we have had the US election, the Dutch election, the French election and now the 'shock' close result in the UK snap election. In each case, investors have to position their portfolios for one or more possible outcomes and commentators have speculated on the impact of the results.

While it is rational to take new information and understand it, making changes to portfolios in advance (or just subsequent to) political events is fraught with behavioral risks that could have a lasting negative impact on portfolios. Our investment team is therefore encouraged to avoid speculating on geopolitics as elections and fundamentals are barely connected. This lack of connection can be shown in several ways:

1. **Elections results are poorly correlated with returns**

The US market is flush with data and has a regular 4-year election cycle, so an effective exercise is to trace back to 1880 and understand the link between elections and the markets. This can be broken up in various ways, including the "left wing" versus the "right wing" and a "large majority" versus "no majority". We can see that the debate between left wing and right wing has not been terribly important to returns, nor has a large majority. However, what would seem to be apparent is that the uncertainty of a close election can drag on returns.

Exhibit 9 Since 1880, we can see that the election outcome has had little bearing on returns, except following close elections (using S&P500 total returns).



Source: Shiller Data, at 31/05/17

2. Investors overreact to election results

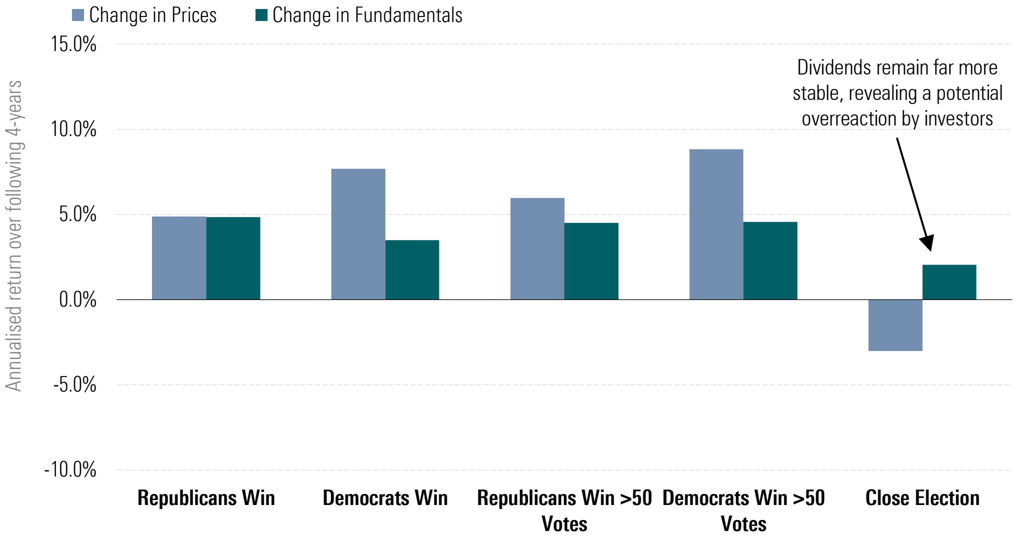
There are two possible ways an investor can interpret the above result. They can apply the speculators mentality and predict similar outcomes, or they can apply an investors mentality and interpret the results against the fundamental impact.

To explain the way an investor can achieve the latter, the same chart can be overlaid with the change in dividends subject to the election. This latter data point helps us to understand the health of the corporate sector, as a sizeable change in dividend policy would be a clear sign that elections matter. We can also understand the relative moves in both the fundamentals and prices to see if investors overreact or not.

We note a few observations from the results below. First, the health of the corporate sector typically remains intact regardless of the winner. Therefore, rather than predicting a crash or worrying about the 'left versus the right', an investor would be better placed remaining impartial to their natural behavioural biases and limit their trading costs.

As we look a little deeper, there would seem to be subtle evidence that dividend growth can be slightly slower following a close election. The historical average of 2.0% growth is below the long-term average of 4.2% in nominal terms, although not sufficiently so to justify the large price moves. However, this may simply reflect other circumstances such as the phase in the economic cycle.

Exhibit 10 If we add the fundamental change, we can see the typical overreaction by investors. This can create mispricing opportunities for patient investors.

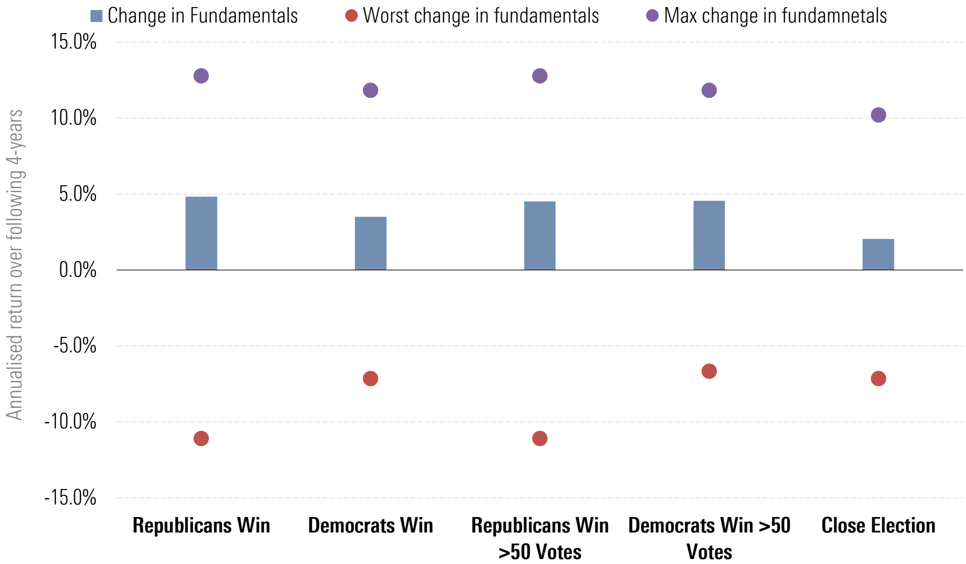


Source: Shiller Data, at 31/05/17

3. Acknowledge the wide range of outcomes

While the above is helpful in understanding the historical averages of both fundamentals and prices, it is also important to recognise the wide range of outcomes. By sticking to a fundamentally-driven approach to elections, we also find a situation where the range of dividend outcomes are largely unpredictable. For example, in 1884, a close election happened to precede a major recession, where dividends fell by -26% over the next four years. In 2004, during a similarly close election, dividends went on to grow by 47% through the 2004-2008 boom. Neither of these outcomes were wholly attributable to the election result and should be recognised as such.

Exhibit 11 The range of outcomes must also be considered. We find that the election result has little influence on the extremity of this range.



Source: Shiller Data, at 31/05/17

So, is a close election a game changer?

The U.K. is the latest in a series of elections that gets the world talking. With the Brexit referendum last June and now a shock election result, investors are understandably trying to work through the clutter and figure out what will happen to corporate Britain.

While we must acknowledge the uncertainty, the logic from the above analysis can be applied anywhere – including the U.K. today. Is this time really that different? And will the election outcome really create a crisis? Maybe, maybe not. What we do know is that the risks are often overstated and investors tend to overreact. For this reason alone, the election result would seem more likely to offer a contrarian investment opportunity than to be feared of.

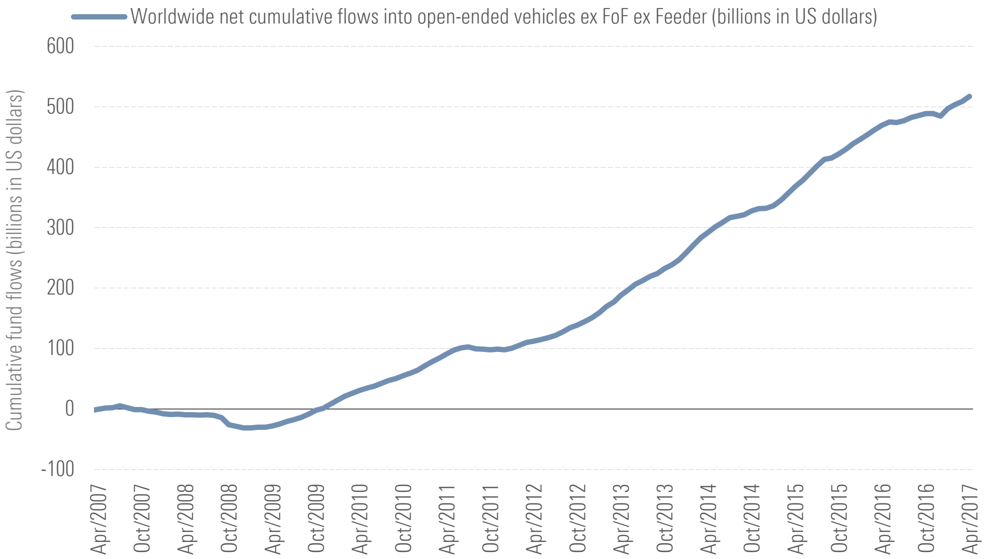
Fundamental Considerations
A reality check for alternative UCITS

By Mike Coop, Head of Multi Asset Portfolio Management, EMEA

For many retail investors, the world of "alternative investments" was off-limits until the launch of the more liquid hedge fund strategies in "UCITS" form several years ago. Their rapid growth in assets under management is evidence of their rising popularity; spurred by professed diversification benefits, lower returns from bonds and fresh memories of equity market losses in 2008 and 2011.

To make the most of these funds, investors need to understand how they differ from the long-standing alternatives such as private equity and traditional hedge funds. Investors also need to understand the role they can play to potentially improve outcomes in a portfolio.

Exhibit 12 The popularity of alternatives as an asset class is alarming.



Source: Morningstar Direct, at 31/05/17

UCITS alternative funds vs conventional alternative funds

You can think of the "UCITS" structure as offering a more regulated subset of the alternative fund universe. It has the aim of making these alternatives more suitable for individual retail investors, introducing limitations and protections not present in standard hedge fund and private equity fund structures. Constraints include limiting the use of leverage, concentration and keeping exposure to illiquid investments low, as well as preventing outright shorting.

The result is that alternative UCITS offer exposure to a very small slice of the full range of alternatives strategies. While many deem this to be a positive development, there is downside as the regulation limits a manager's capacity to generate returns as well as manage risk and diversify traditional portfolios.

What are the key issues to consider?

It's worth noting that the range of strategies and the fund managers on offer are generally less well known than with conventional equity or fixed income. It is therefore very important to understand what you are getting and its total portfolio impact. The three key things to consider are:

1. Is the investment strategy clear?
2. Is it bringing something different to the portfolio that will be diversifying in a crisis?
3. How much can it add to total portfolio returns given the fees?

These holistic considerations are worth elaborating on as they are imperative in a total portfolio context. The key inference is that an 'alternative' fund is only truly alternative if it brings something to the table that traditional assets can't. The investor must also get their fair share of any returns to make it worth their while.

Investment Strategy

In essence, alternative UCITS can own traditional securities as well as derivatives such as futures or options. Currency exposures are also typically actively managed. To navigate your way around the strategies on offer, you can use the Morningstar categories of liquid alternative strategies:

- Long short equity
- Long short credit
- Managed futures
- Market neutral
- Multi alternative
- Option writing
- Multi currency
- Bear market

Given the broad opportunity set these mandates offer, close monitoring is needed given the more frequent changes and greater discretion when compared to conventional funds. As with any investment, it is essential to understand the risks associated with the strategy and the range of potential outcomes.

Diversification Impact

One of the primary motivations for alternative UCITS exposure is to look for strategies that offer something different from the equity and fixed income exposures one may already have. Choosing strategies that complement rather than replicate what your active equity and fixed income managers are doing is therefore very important.

For example, check that your macro hedge fund is not simply taking the same exposures as your active global fixed income managers, since both will typically use economic insights to choose between currencies, different durations and different amounts of credit risk.

Most important of all, total portfolio diversification is most needed when equities sell off heavily, so understanding how the strategy will perform in this environment is crucial.

Return Impact

Alternative UCITS are not risk-free investments so returns need to be above those of cash to reward investors for this extra risk. The three drivers of the return investors get are (1) market returns that come from the market exposures or beta of the fund; (2) excess returns that come from the manager's active decisions vs the market exposures; and (3) total fees and expenses.

For example, the market exposure of 'equity long/short funds' are typically "net long", meaning the exposure adds to returns when equity markets rally and detracts when they fall. The largest market exposure for 'market neutral' funds tends to be cash. Therefore, one should make sure they don't end up with either "expensive beta" propositions that act like traditional assets under stress or "cash proxies" that deliver a low return and charge high fees for the privilege. These expenses are a distinguishing feature as they are often higher than those of traditional managers and can include performance-related fees.

How does this work in practice?

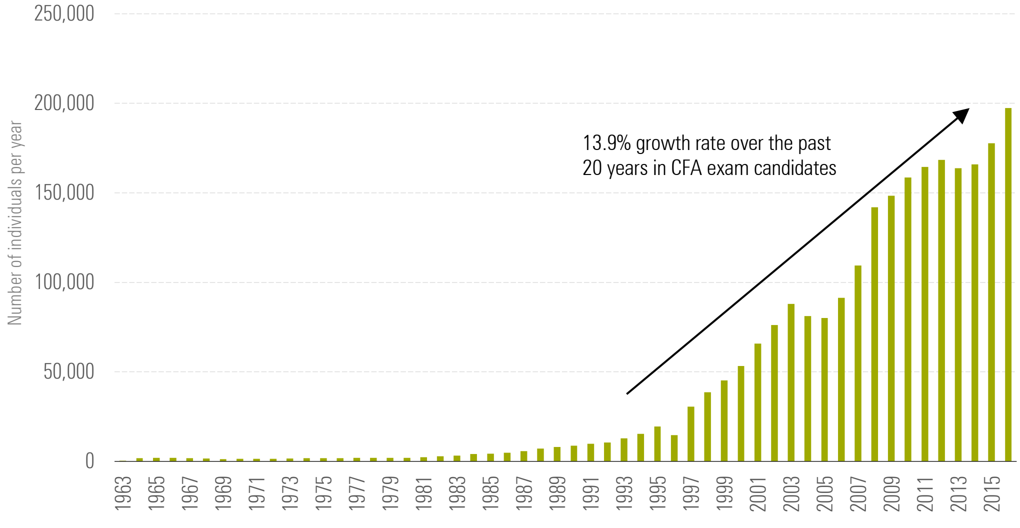
The overwhelming theme when considering alternative UCITS is to be disciplined and selective. Alternative UCITS can provide exposure to diversifying strategies with the potential to enhance total portfolio returns – however it is not always safe to assume this is going to be the case. The constraints imposed on alternative UCITS mean that only a fraction of the full gamut of alternative strategies is available. By extension, the constraints also limit the scope for generating returns and managing risk.

In our experience, better outcomes are likely if you are highly selective in this space. One should allocate and size these positions appropriately and always keep in mind what they offer relative to equities, bonds and cash. Caveat emptor!

Investor Behaviour
Is the popularity of the CFA a good thing for investors?

There might be something addictive about the complex, challenging and competitive undertaking that we call investing. While some may have thought the financial crisis would cause a decline in professional investing, the statistics are telling us the opposite. According to the Chartered Financial Analyst Institute, more than 172,000 people sat one of the three CFA exams this month, and with at least another 50,000 expected to sit the first exam in December, the numbers for 2017 look certain to hit another record high. It is worth highlighting the structure and rigor of the CFA, with a very low pass rate by industry standards and a high commitment generally involved. In this regard, Morningstar fully supports the motivations of the CFA Institute and perceive it as a highly desirable qualification among its team.

Exhibit 13 The number of individuals sitting the CFA exam is growing at a strong rate.



Source: CFA Institute, Morningstar Investment Management calculation at 31/05/17

Looking more broadly, this shift towards smarter and better educated investors has theoretical implications for all of us. The fact that institutional fund flows have increased relative to retail flows could support the theoretical decline in an analytical 'edge'. Back in the 1950's, Warren Buffett and Benjamin Graham were swimming in a pool of relatively undereducated and uninformed investors; a time when the CFA didn't even exist and the powers of the internet were unknown.

A lot has changed in the last few generations and a lot more will change in the coming 50+ years. By its very nature, it would seem that competitiveness will further intensify and greater access to information should theoretically put pressure on pricing anomalies that lead to excess returns. Rather ironically, this could further play into the 'passives' dominance as markets theoretically become more efficient.

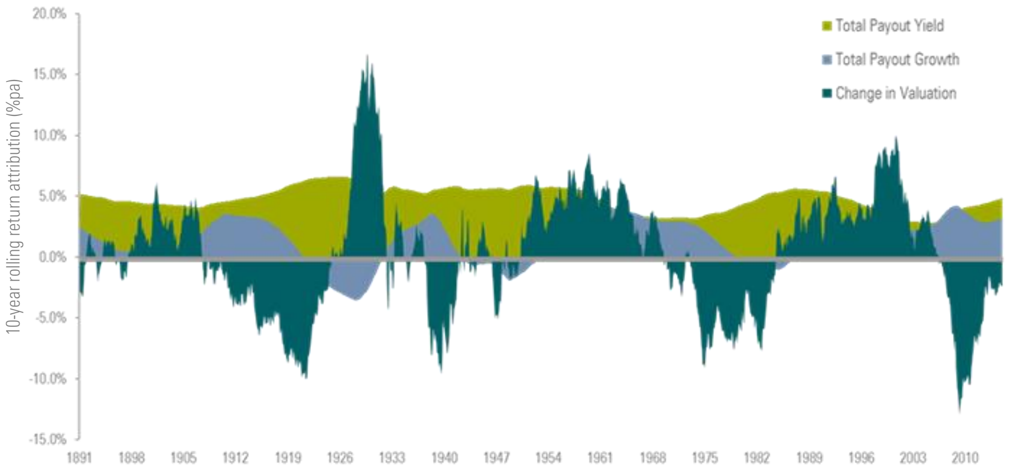
Building portfolios for tomorrow

With such an interesting twist to modern finance, it begs the question what an investor can do about it. Is active investing really a dying breed? What is the most rational way to construct multi-asset portfolios in a world for tomorrow?

This is where an investor should apply some perspective and focus on what really matters. If we look back over history, we know that approximately 98% of returns are attributable to 'fundamentals' – namely, dividends and payout growth[6]. While prices can and do deviate in the shorter-term, these fundamentals are the baseline that pegs long-term returns with magnetic force.

Why is this important? It is all about focusing on what really matters and understanding the way investors move around it.

Exhibit 14 We can see that the 'change in valuations' remain an important component of the investment return. While fundamentals ultimately matter, a contrarian approach could be warranted (10-year rolling return attribution).



Source: Morningstar Investment Management calculation at 31/05/17

This exhibit shows the rolling 10-year 'change in valuation' shift over time, and while it eventually nets out, valuation anomalies continue to emerge despite the collective efforts of an increasingly intelligent investor base. As these anomalies are evidence of a continuing disconnection between the expectations of investors, we can conclude that behavioural biases remain regardless of our education.

Warren Buffet put this best when he said, "to invest successfully does not require a stratospheric IQ, unusual business insights, or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding the framework."[7].

To say this another way, if we all study the same tests the possibility of confirmation bias increases. Therefore, while it seems logical that the market would become more efficient as education standards rise, the 'change in valuations' is as volatile as ever, showing that we have a long way to go before investors properly control their behaviour and act rationally at all points of the cycle.

6 Sourced from Philip Straehl & Roger Ibbotson's paper 'The Long-Run Drivers of Stock Returns: Total Payouts and the Real Economy

7 Sourced from Warren Buffett's introduction to the fourth revised edition of 'The Intelligent Investor' by Benjamin Graham in 1973

This opens an exciting pathway for investors. Most prominently, behavioural finance continues to hold many lessons about investing.

Moreover, we know that stock prices are not always supported by their fundamentals in the shorter term and humans will continue to be subjected to distinctive behavioural biases. Somewhat paradoxically, this is a key reason to be optimistic about active management playing a role in the industry going forward. So long as humans have behavioural input into the investment process, the market will continue to have inefficiencies. This will happen regardless of the number of CFA graduates in the system.

Summary
Finding peace in the universe

Managing money is not getting any easier, but it is getting smarter. The rise of information, particularly via analytics tools and behavioural insights, are helping investors understand the contrarian nature of successful investing.

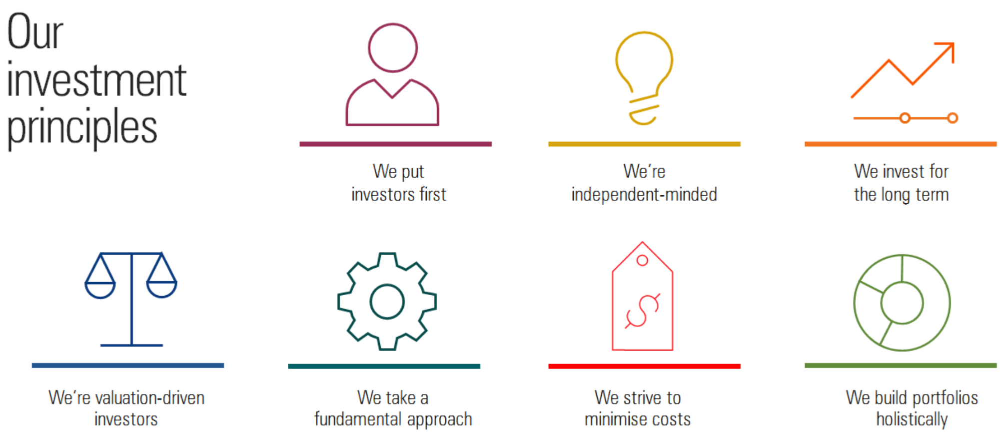
Yet, at the same time, the investing landscape is becoming more challenging for professionals and amateurs alike. Low yields continue to put abnormal pressure on current investor returns, while high prices reduce the returns that investors can expect in the future. In this environment, it is essential that investors resist the urge to chase prices higher, as it can result in an ever-decreasing return for the risk they are accepting. Equally, it is important to pay more attention to investment timescale than may usually be done. When few assets appear attractive, the potential of poor short-term returns is higher and therefore an investors ability to remain invested over the long term is increasingly important.

To overcome such issues, many investors are seeking new solutions to these challenges by investing heavily in alternatives. The hope is that they will both protect capital and deliver real returns. While we have some empathy with this approach, these enthusiasts of alternative investments can be likened to pioneers such as Elon Musk and Jeff Bezos that seek radical solutions to the challenges we face on earth. While we wish them well, it is important to remember that there are 7 billion others still figuring out the best way to live life on earth. In many ways, the same principle applies to investment markets, where the pursuit of alternatives must be balanced against the opportunities in traditional markets.

In the long-term, it is this holistic approach that harvests the best results.

"Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing."

- Warren Buffett[8]



[8] From his BusinessWeek interview on Jun. 25, 1999

About Morningstar Investment Management Europe

Drawing on our core capabilities in asset allocation, manager research and portfolio construction, Morningstar Investment Management Europe Limited creates customised investment solutions to help financial institutions meet investor needs. We have both a global point of view and local market expertise, delivered through an international network of experienced investment professionals who specialise in serving regional markets.

When building investment offerings, we benefit from access to information from one of the largest investment databases, as well as patented methodologies, intuitive technologies and decades of research. Our independence and strong investor focus allow us to develop solutions that help clients stand out within their markets. Our clients include many of the top wealth management firms, insurance companies, banks, asset managers, and retirement plan providers.

Our investment processes incorporate the rich heritage of Ibbotson Associates, a leading independent asset allocation provider offering investment advisory services, retirement advice programs, and customised research. Ibbotson applies academic research to create real-world solutions for financial institutions. Ibbotson was founded in 1977 and is a Morningstar company.

Feedback

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